CHAPTER 4

REDUCE RECORDKEEPING AND COMPLEXITY

Simplification is advanced by a number of the Administration proposals discussed in other chapters. This chapter is devoted to proposals particularly aimed at reducing recordkeeping and complexity for individuals.

The proposals would repeal the political contribution credit, the presidential campaign check-off, and the adoption expense deduction. A floor would be imposed on employee business expenses and miscellaneous itemized deductions. Income averaging would be repealed in light of the flatter tax rate schedules and lower marginal tax rates under the Administration proposals. Finally, the penalty provisions would be rationalized and simplified.

IMPOSE FLOOR ON EMPLOYEE BUSINESS EXPENSE AND OTHER MISCELLANEOUS DEDUCTIONS

General Explanation

Chapter 4.01

Current Law

Four categories of employee business expenses may be deducted by taxpayers regardless of whether they itemize deductions. These are:

- expenses paid by the employee and reimbursed by the employer;

- employee expenses of travel, meals, and lodging while away from home;

- employee transportation expenses; and

- business expenses of employees who are outside salesmen.

Various miscellaneous itemized deductions are allowed for taxpayers who itemize deductions. These miscellaneous itemized deductions comprise all itemized deductions other than medical expenses, charitable contributions, interest, taxes, and theft and casualty losses. They include:

- employee business expenses other than those described above, including educational expenses, union and professional dues, safety equipment, small tools, supplies, uniforms, protective clothing, professional subscriptions, and employment agency fees;

- gambling losses not in excess of gambling winnings;

- expenses of producing certain income, including fees for investment services, safe deposit box rentals, trustee fees, and tax return preparation and tax advice fees.

Reasons for Change

Allowance of the various employee business expense deductions and the miscellaneous itemized deductions complicates recordkeeping for many taxpayers. Moreover, the small amounts that are typically involved present significant administrative and enforcement problems for the Internal Revenue Service. These deductions are also a source of numerous taxpayer errors concerning what amounts and what items are properly deductible.

Proposal

Employee business expenses (other than those reimbursed by the employer) and the miscellaneous itemized deductions would be consolidated into a single category, together with the deduction for State and local taxes (other than income taxes) which are currently required to be itemized on Schedule A but which are incurred in carrying on an income-producing activity. To the extent that these items, in the aggregate, exceed one percent of a taxpayer's adjusted gross income ("AGI"), they would be deductible by the taxpayer, whether or not he itemizes deductions. The amount allowed as a deduction would reduce the taxpayer's adjusted gross income. However, the one percent floor would be based on AGI as computed without regard to the deduction. In lieu of a deduction, employer reimbursements would be excluded from the employee's income to the extent that the employee would have been entitled to a deduction without regard to the one percent floor.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

Disallowance of a deduction for a normal level of employee business expenses and miscellaneous itemized deductions would simplify recordkeeping, reduce taxpayer errors and ease administrative burdens for the Internal Revenue Service while still providing fair treatment for taxpayers who incur an unusually high level of such expenses.

In 1982, one-half of all itemizers claimed miscellaneous deductions of less than one-half of one percent of their AGI. Fifty-eight percent claimed deductions of less than one percent of their AGI, and 93 percent claimed deductions of less than five percent of their AGI. Thus, introduction of a floor or threshold of one percent of AGI would substantially reduce the number of returns claiming this deduction.

REPEAL POLITICAL CONTRIBUTION CREDIT

General Explanation

Chapter 4.02

Current Law

Individuals are allowed a nonrefundable tax credit for contributions to political candidates and political action committees. The credit equals one-half of the first $100 ($200 for joint returns) of an individual's contributions during the year.

Reasons For Change

The tax credit for political campaign contributions is not related to the proper measurement of income, but rather is intended to encourage individuals to contribute to the cost of the political process. The efficacy of the political contribution credit in producing additional political contributions is open to question. The credit produces no marginal incentive for taxpayers who without regard to the credit would make contributions of $100 or more. The credit also creates no incentive for low-income individuals who have no income tax liability.

The political contribution credit presents administrative and compliance problems for the Internal Revenue Service. The subject matter of the credit may involve the Internal Revenue Service in sensitive inquiries about political affiliation. Moreover, the small dollar amounts involved on each tax return make verification difficult and expensive relative to the revenue at stake. There are some indications that increasing numbers of taxpayers may be claiming credits for which no contributions have been made.

Finally, the political contribution credit creates complexity for taxpayers. It adds a line to income tax forms and entails an additional recordkeeping burden.

Proposal

The credit for political contributions would be repealed.

Effective Date

The repeal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

In 1982, the political contribution credit was claimed on about 5.2 million returns, or about 6.6 percent of all individual returns with some tax liability before deducting tax credits.

As shown in Table 1, the number of users of the credit is skewed heavily toward higher-income taxpayers. Only 2.8 percent of all returns with income of $10,000 or less (and with some tax liability) used the credit whereas 38.4 percent of all returns with income of $100,000 or more claimed the credit. However, because the credit is limited to $50 ($100 on joint returns), tax benefits slightly favor those in lower-income brackets. In 1982, the Federal revenue loss from the credit was $270 million. The percentage distribution of those benefits is shown in the Table 1.

Table 4.02-1

Use of the Political Contributions Tax Credit -- 1982

AGI Class	Percentage of Returns Claiming the Credit 1/	Distribution of Tax Benefit from Credit	Distribution of Tax Liability
$ 0 - 9,999	2.8 %	8.2 %	2.5 %
10,000 - 19,999	4.5	17.1	12.5
20,000 - 29,999	6.5	20.9	18.8
30,000 - 49,999	10.0	29.4	30.8
50,000 - 99,999	20.8	16.6	18.2
100,000 or more	38.4	7.8	17.2
All Returns	6.6 %	100.0 %	100.0 %

Office of the Secretary of the Treasury May 28, 1985

1/ Percentage of all returns with some tax liability before tax credits.

Even if a large portion of the tax reduction attributable to the credit is not simply a windfall benefit to taxpayers who would have made a contribution anyway, the total subsidy from the credit represents only a small portion of total political campaign expenditures in the United States.

Repeal of the credit would not cause a significant increase in tax liability for any group of taxpayers.

REPEAL PRESIDENTIAL CAMPAIGN CHECK-OFF

General Explanation

Chapter 4.03

Current Law

The Presidential election campaign check-off permits each individual who has income tax liability to elect to have one dollar of that liability used to finance Presidential election campaigns. By statute, the check-off information must be either on the first page of the income tax return or on the page that bears the taxpayer's signature.

Reasons For Change

The Presidential election campaign check-off is unrelated to the purposes of the income tax and is a source of complexity for taxpayers. The check-off does not directly affect individual tax liabilities, but simply allows taxpayers to direct that a small portion of their taxes be spent in a particular way. The use of the tax return system for this purpose is unique to the campaign check-off. For the many taxpayers who do not understand its purpose or effect, the check-off is a source of confusion. In addition, the check-off complicates tax forms, significantly in the case of the shorter forms, such as the 1040EZ.

Proposal

The Presidential election campaign check-off would be repealed.

Effective Date

The repeal would be effective for tax liability in taxable years beginning on or after January 1, 1986.

Analysis

Approximately one-fourth of all taxpayers (one-third of those taxpayers with some income tax liability) use this provision to earmark funds for Presidential campaigns. The percentage of taxpayers using the provision varies somewhat between election and nonelection years.

Since use of the campaign check-off does not increase any individual's income tax liability, taxpayers would not be adversely affected by repeal of this provision. Repeal of the check-off would eliminate public funds for Presidential campaigns unless direct appropriations were provided.

REPEAL ADOPTION EXPENSE DEDUCTION

General Explanation

Chapter 4.04

Current Law

Current law permits a deduction for "qualified adoption expenses" paid or incurred during the taxable year. In general, qualified adoption expenses include the reasonable and necessary adoption fees, court costs, attorney's fees, and other expenses directly related to the legal adoption of a "child with special needs" as defined in the Social Security Act.

The maximum amount of qualified adoption expenses that may be deducted with respect to a child is $1,500. Moreover, no expense may be deducted as a qualified adoption expense if a credit or deduction is otherwise allowable for such expense or if such expense is paid for by a grant from a Federal, State, or local program.

Reasons for Change

The allowance of a deduction for certain adoption expenses is an inappropriate way of providing Federal support for those who adopt children with special needs. Federal programs supporting such children or the families who adopt them should be under the supervision and control of agencies familiar with their needs. Such agencies should also have budgetary responsibility for the cost of programs serving these purposes. Providing Federal support through the tax system is inconsistent with each of these objectives.

Proposal

The deduction for qualified adoption expenses would be repealed.

Effective Date

The proposal would generally be effective for taxable years beginning on or after January 1, 1987, and would generally apply to expenses paid or incurred after such date. Taxpayers having incurred qualified adoption expenses with respect to a child before January 1, 1986, would be entitled to deduct qualified adoption expenses paid or incurred after the effective date with respect to such child.

Analysis

It is anticipated that a direct expenditure program would be enacted to continue Federal support for families adopting children with special needs. The effective date of such program should be coordinated with the proposed repeal of the current deduction.

REPEAL INCOME AVERAGING

General Explanation

Chapter 4.05

Current Law

Because of the progressive tax rate structure, an individual whose income varies widely from year to year pays more tax over a period of years than an individual who earns comparable income evenly over the same period. The income averaging provisions mitigate this effect. Under these provisions, if an eligible individual's income for the taxable year exceeds 140 percent of his average income for the three preceding years ("base years"), the effective tax rate applicable to such excess income ("averagable income") generally will be the rate that would apply to one-fourth of the averagable income. The individual's tax liability will be an amount equal to the sum of (i) the tax on 140 percent of the three-year base period income, plus (ii) four times the extra tax from stacking one-fourth of the averagable income on top of 140 percent of base period income.

Two basic eligibility requirements restrict the availability of income averaging. First, the individual must have been a citizen or resident of the United States during the current year and each of the base years. Second, the individual (and the individual's spouse) generally must have provided at least 50 percent of his or her support during each of the three base years. This support test need not be satisfied if:

(1) the individual has attained the age of 25 and was not a full-time student during at least four years after attaining the age of 21;

(2) more than one-half of the individual's taxable income for the current year is attributable to work performed during two or more of the base years; or

(3) the individual files a joint return for the current year and not more than 25 percent of the aggregate adjusted gross income on the joint return is attributable to such individual.

Reasons for Change

Income averaging was intended to provide taxpayers whose income fluctuates widely from year to year with relief from the effect of the progressive rate structure. The changes in the rate structure included in the Administration proposal would reduce the need for income averaging in two respects. First, with fewer but wider brackets, taxpayers would be able to experience greater fluctuations in income without becoming subject to higher progressive rates. Second, with the overall reduction in marginal rates, the additional tax paid as a result of large income fluctuations would generally be less.

The eligibility requirements and computations relating to income averaging are extremely complex. In spite of that complexity, current law does not succeed in restricting the benefits of income averaging to taxpayers with widely fluctuating income. Thus, many of the beneficiaries of income averaging are taxpayers who experience sharp, sustained increases in income, such as young people who complete their studies and enter the work force for the first time. The availability of income averaging for such taxpayers is inconsistent with the principles of a progressive tax system.

Proposal

The income averaging provisions would be repealed.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

For taxpayers with truly fluctuating income, the need for income averaging would be reduced by the proposed rate structure. Repeal of the income averaging provisions would simplify the tax code and forms.

SIMPLIFY PENALTY PROVISIONS

General Explanation

Chapter 4.06

Current Law

The Internal Revenue Code provides civil penalties for failure to file information returns and for failure to furnish statements to persons with respect to whom an information return was required to be filed. The amount of the penalty is $50 for each statement or return that is not filed or furnished. Some of the penalty provisions have a $50,000 per year maximum amount. The Code does not provide a penalty (except a $5 penalty for failure to include a correct taxpayer identification number) for including incorrect information on information returns or statements.

The Code provides a penalty for failure to pay tax when due of 0.5 percent of the overdue tax per month, not exceeding 25 percent.

Reasons for Change

An effective system of information reporting is essential to ensure even-handed enforcement of the tax laws, to broaden the tax base by including currently unreported income, and to facilitate a shift to a largely return-free system. The present penalty structure, which is the result of piecemeal additions to the Internal Revenue Code, does not provide a clear, consistent set of rules covering information reporting violations. In addition, maximum penalty amounts undermine horizontal equity and weaken the information gathering system.

The existing penalty for failure to pay taxes when due is overly burdensome, and generally falls on taxpayers whose failure to pay is not willful.

Proposal

The penalties for failure to furnish copies of information returns to payees would be eliminated as a separate section of the Internal Revenue Code and would be incorporated into the existing provision for failure to file information returns. A new penalty provision also would be included in the same section for filing an incorrect return or statement. The amount of the penalties, generally the same as current law, would be as follows:

(a) failure to file information return: $50 for each return;

(b) failure to furnish statement to payee: $50 for each statement; and

(c) furnishing incorrect information on a return or statement: $5 for each incorrect return or statement.

The current $50,000 maximum on certain information return penalties would be eliminated. Failure both to file an information return and to furnish a statement to a payee would result in a combined penalty of $100. Only one $5 penalty would be imposed for a return or statement that included more than one piece of incorrect information.

In addition, the present penalty for failure to pay taxes would be eliminated and replaced with a cost of collection charge. Current law does not permit the charging of collection fees, which is standard practice in the private sector. This proposal would allow the Internal Revenue Service to recoup its cost of collecting delinquent amounts and would encourage taxpayers to pay more promptly. Like penalties, this fee would not be deductible by taxpayers.

Effective Date

The proposals would apply to returns due on or after January 1, 1986 (determined without regard to extensions).

Analysis

The proposed restructuring of the penalty provisions should promote simplification in the administration of the provisions and provide greater fairness in their application. The proposal would integrate certain information reporting penalties into a single provision which should promote compliance with the tax laws by enabling taxpayers to understand more easily the consequences of noncompliance.

Under the proposal, the existing heavier penalty for intentional disregard of the filing requirements would remain intact and would be imposed if the violation is willful rather than merely inadvertent or careless. The proposal does not affect existing penalties for information returns involving foreign persons or transactions, employee plans, or exempt organizations.

The elimination of the $50,000 maximum penalty amount would serve the interests of fairness and compliance. Maximum penalty amounts do not encourage compliance with the tax laws, nor do they promote uniformity of treatment. There is no reason, for example, that an employer who fails to file 5,000 W-2 reports should receive relatively more favorable treatment than an employer who fails to file 50 or 500 such reports. Yet that is the result under current law, which imposes a statutory maximum on the penalty paid by the larger employer.

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